



Consumer Federation of America

**Testimony of
Senator Howard M. Metzenbaum (Ret.)
Chairman, Consumer Federation of America**

**Before the Subcommittee on Consumer Affairs, Foreign Commerce
and Tourism of the Senate Commerce, Science
and Transportation Committee**

On Improving Corporate Responsibility and Accountability

July 18, 2002

Good morning, Chairman Dorgan, Senator Fitzgerald and members of the Subcommittee. My name is Howard M. Metzenbaum and I now serve as Chairman of the Consumer Federation of America (CFA). CFA is a non-profit association of some 300 pro-consumer organizations with a combined membership of over 50 million Americans. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is one of CFA's top priorities.

I appreciate your invitation to offer my comments on the very important issue of corporate responsibility. I am especially pleased to appear before you, Senator Dorgan, because you have done so much to highlight corporate abuses of late and to propose real reform.

I spent my career in the U.S. Senate working to prevent corporations from running roughshod over the rights of consumers and workers. I have to tell you that I have never seen a more appalling example of heartless, unfettered corporate greed than that revealed by the recent, widespread accounting scandals. Companies like Enron and Worldcom lied to their investors, lied to their employees, hid crucial information about their finances and, in some cases, tried to improperly influence government officials. The executives behind what appears to have been massive frauds on a grand scale should be brought to justice quickly. This includes officers at companies like Worldcom, if they are found to have committed fraud, as well as the individuals at accounting firms who should have known when their clients were cooking the books.

The truth is this country finds itself in the midst of a corporate crime wave. And while average citizens ponder their diminishing retirement accounts and wonder whether they will be next to lose their jobs, a debate rages in Washington over whether this is the product of a few bad apples or evidence of a systemic break-down. While that may seem to be an arcane argument in the face of so much real world pain, the implications of this debate are significant because the outcome will determine whether Congress and the administration adopt an effective policy response.

The administration has been cynically arguing the "bad apple" theory. They have used this theory to justify a policy that allows them to talk tough about sending corporate crooks to jail without

forcing them to impose real reforms on the corporate interests that so generously fund their campaigns. Now most of us can agree that corporate crooks should spend some time behind bars, but this argument misses on two counts. First, what we are looking at here is more than a few bad apples. Secondly, what we have is a system of investor protections specifically designed to eliminate the bad apples; a system that clearly is not working.

One measure of the scope of the problem is the recent dramatic rise in companies forced to restate their earnings. Back in the early 1990s, that number used to run at a predictable 45 or so a year, but around the middle of the last decade, it took off. From 1997 through 2001, there were 1,089 restatements, according to a recent study by the Huron Consulting Group. The number grew every year over that five-year period, from 116 in 1997 to 270 in 2001. The companies involved include such well-known examples as Waste Management, Sunbeam, Cendant, Rite Aid, and, of course, Enron -- accounting failures that together cost investors hundreds of billions of dollars in lost market capitalization. But, they do not include Adelphia or Xerox or Worldcom or any of the other companies whose actions have promised to make 2002 another record-breaking year. Today, we are fast approaching the point where one in ten of America's public companies will have recently been forced to restate its earnings. That is a lot of bad apples.

Furthermore, the companies involved are not unknown fly-by-night operations, but the very symbols, in many cases, of innovative American capitalism -- Enron, Worldcom, Qwest, and Xerox -- a company that, as one writer put it is "so established that its name has become both noun and verb." Even if you were to accept the argument that we are dealing with isolated cases of wrong-doing, when they involve the nation's leading companies, does that not tell you the system is fundamentally broken?

But the real point is that our system of investor protections was ostensibly designed with the bad apples in mind. It was designed to work, not just when corporate executives are honest, forthcoming and aboveboard, but also when they are greedy, unethical, and deceptive. First and foremost, it is why we require an outside, independent auditor to review and approve a company's financial statements. It is why we have standardized rules that govern what companies have to disclose and how. It is why the SEC reviews financial disclosures for accuracy, completeness, and compliance with appropriate

accounting rules. It is why rating agencies pore over massive amounts of information to determine the creditworthiness of companies that issue debt. It is why corporate boards have audit committees, made up primarily of board members who are supposed to be “independent,” to supervise the audit.

In the recent rash of accounting frauds and failures, all of those safeguards failed. The accounting rules failed to produce an accurate picture of company finances. Corporate boards failed to ask tough questions, challenge questionable practices, or require disclosure that is more transparent. Auditors signed off on financial statements that clearly presented a misleading picture of company finances -- or missed altogether Mt. Everest sized reporting errors. In many cases, years had passed since the SEC last reviewed the company in question's financial statements.

At the end of the day, one conclusion is inevitable. The system of corporate governance that we have long, and rightly, touted as the world's best is not adequate to ensure that investors receive accurate information about the companies in which they invest. And that has led to the current crisis of investor confidence. Although most investors instinctively understand that not all companies are corrupt, they also know that they can not -- on their own -- reliably tell the difference between those whose finances toe the mark and those with troubling secrets hidden in the footnotes or kept out of the financial statements altogether. They have experienced first-hand how quickly the bottom can drop out of a once high-flying stock when questions about its accounting emerge.

Another aspect of the current debate swirls around the question of whether this recent explosion of corporate greed is something new or not. The latter argument is based on the theory that the recent revelations of corruption in the boardroom are simply the inevitable hangover from the market boom - - that this is simply how markets "correct" themselves, and we should simply get out of the way and let the market do its work.

This argument also ignores an important point -- that our markets are no longer simply a place where the rich get richer. Increasingly, the financial markets are where average, middle class Americans put their money to save for retirement, to buy a home, or to send their children to college. Since the time when the first President Bush took office, the number of Americans investing in our markets has grown by roughly 60 percent. Today, approximately half of all households have money invested either

directly or indirectly in the stock of American companies. It is this massive new influx of capital from average Americans that provided the fuel for our recent period of unprecedented economic growth.

When the bottom drops out, what these middle class families have at risk is not whether they can vacation in Tuscany this year, or if they will have to stay a little closer to home. It is not whether they have to give up the private jet, or delay their plans to build a vacation home in Aspen. What is at risk is whether they will be able to retire in reasonable comfort, or even retire at all. What is at risk is whether their children will be able to attend the college of their choice, settle for a less expensive alternative, or miss out on college altogether. What is at risk is whether they will have to delay indefinitely their ability to participate in the American dream of owning their own home. So, what is new is not just that the investor losses from the recent spate of accounting failures are unprecedented in their size, but that families who are far less able than the investing class of the past to absorb such losses are feeling them.

If we want average Americans to continue to view our financial markets as a place where they can entrust their long-term savings, then we need to provide them with reasonable assurance that our system of investor protections is once again functioning as it should. That will require comprehensive reforms. While a strong civil and criminal enforcement program is a crucial element of such a plan, the President's plan does not go far enough. He has given no indication that he is willing to fund the increased enforcement he is highlighting. His recent speech said nothing about new funding for the Department of Justice, which is already struggling with massive new responsibilities from the war on terror. The added \$100 million he has proposed for the SEC is like throwing a drowning man a toothpick when what he needs is a lifeboat.

The House bill is a disaster. It does nothing to enhance auditor independence beyond what the major firms have said they would not oppose. Its supposedly independent oversight board for auditors would allow a super-majority of industry representatives. And the mechanism it relies on to create the board -- where a board applies for the job -- invites an industry take-over. This is sham reform that, in all but name, perpetuates the current system of self-regulation.

Nor does the Senate accounting reform bill do the job, although it is far superior to the

President's proposal and the House-passed bill. It would be far better, for example, if it included your amendment, Senator Dorgan, to open up the proceedings of the accounting oversight board to the public or amendments offered by you or your colleague Senator McCain to insure that the SEC imposed a broad ban on consulting services by accounting firms when they are also auditing a particular company. It would be far better with the amendments offered by Senator Boxer to enhance the independence of the oversight board.

Although we were very disappointed that these amendments were never voted on and that this important opportunity to improve the bill was missed, make no mistake about it. The Senate bill is still by far the best reform proposal on the table. It is the only proposal to create a strong, effective new oversight board for auditors; to include significant provisions to strengthen corporate board oversight of the audit and enhance its independence; to lengthen the statute of limitations for securities fraud; and to protect the independence of the Financial Accounting Standards Board. Like the House, but unlike the President's proposal, the Senate bill authorizes a meaningful and much needed increase in SEC resources.

In short, the Senate bill is the minimum needed to justify renewed investor confidence in the reliability of corporate disclosures. To ensure that the best possible bill is passed as quickly as possible, the House should accede to the Senate bill. If it refuses, then at the very least, Senators should insist that the conference is held in public. That would minimize the danger that the opponents of reform, who are nervous about gutting the bill in public, would be bolder in behind-closed-doors bargaining sessions.

But even if the Senate bill is adopted intact, more needs to be done. In developing an agenda of additional reforms, policy makers need to recognize that one reason the system has run amok is that too many of the financial incentives reward doing the wrong thing. If you want to bring about a new era of corporate responsibility, you are going to have to eliminate those perverse incentives.

Stock options should be expensed

The Senate bill would enhance the independence of the Financial Accounting Standards Board. Maybe that will give FASB the courage to do what it was intimidated to do nearly ten years ago -- require that stock options be reflected as an expense on corporate balance sheets.

Proponents of stock option compensation argue that this practice benefits shareholders by aligning the interests of company executives with those of company shareholders. But that is clearly not true. As Paul Krugman recently wrote in *The New York Times*, options allow executives to "get a share of investors' gains if things go well," but don't force them to "share the losses if things go badly." As a result, and because of the massive size of many options grants, they offer executives massive personal financial incentives to take whatever risks necessary to drive up the stock price in the short term.

Clearly, granting executives shares of company stock, and forcing them to hold that stock until after they leave the company, would do a far better job of aligning their interests with those of typical shareholders. But our accounting rules favor stock option compensation over grants of company shares. This is because the grant of company shares would have to be reflected immediately as an expense on balance sheets, while the stock options can be relegated to the footnotes without denting earnings. That makes no sense. As others have pointed out -- while it may be difficult to pin a precise value on options when they are granted, the one thing we do know is that their value is not zero.

If we truly want to align company executives' interests with shareholders -- a laudable goal -- we need to remove this perverse incentive in our accounting rules to use stock options rather than grants of company shares to provide incentive compensation to executives. But, despite the admirable efforts of Senators Levin and McCain, this aim was not included in the recent Senate corporate reform bill. The bill is incomplete without it.

Improve corporate board oversight of management

With all the focus on stock options, it is important to remember that personal greed is not the only factor encouraging company executives to push share prices ever higher. As Steve Liesman wrote in the *Wall Street Journal* last January, "stocks have become a vital way for companies to run their businesses." Companies use stock to make acquisitions and to guarantee the debt of off-the-books partnerships. They rely on the stock market as a place to raise capital. As a result, as Leisman said, "a high stock price can be the difference between failure and success."

Clearly, simply fixing the accounting for options will not be enough to eliminate the incentive for

corporate executives to do whatever it takes -- including cooking the books -- to create the financial picture necessary to produce a rising stock price. Corporate boards are going to have to do a better job of keeping management on the straight and narrow.

In theory, corporate board members are supposed to represent shareholders. But shareholders don't pick board members, CEOs do. Recent proposals by the New York Stock Exchange and Nasdaq take a step in the right direction by strengthening the independence requirements for independent board members and by requiring that all members of the audit and compensation committees be independent members. However, they are not enough to overcome the influence management has by virtue of the fact that it selects the board -- and can stack it with cronies and 'yes' men or boot those board members they view as trouble makers.

If we want corporate boards to represent shareholders, we need to do a better job of giving shareholders a say in the selection of board members. This is an area that we believe deserves additional attention in the coming months.

Make the independent audit truly independent

Ultimately, however, the ability to ensure reliable disclosures comes down to the effectiveness of the independent audit. Nothing else can substitute for having a skeptical, independent outsider who thoroughly looks over the books. But, here again, auditors faced with bogus accounting have overwhelming financial incentives to look the other way. Challenging management could cost them the audit engagement. Given the decades-long relationships that are typical between auditors and their clients, that means losing not just this year's audit fee, or next year's audit fee, but decades of expected income. If the client is a big one, the incentive to back down is enormous.

One thing that dramatically ups the ante is the increasingly common practice among auditors of also providing consulting services to their audit clients. The practice has become all but universal among large companies, and the dollar amounts on the table for consulting contracts are typically two or three times the audit fees. In some cases, however, the imbalance is much greater, with consulting fees in some cases bringing in twenty or thirty times the audit fees.

It is no wonder that expert after expert who testified before House and Senate committees said

no reform would be complete without a broad ban on consulting services and mandatory rotation of audit firms. Unfortunately, these central reforms never made the cut. The House bill simply does what the major accounting firms said they would not oppose -- it expands the current ban to include internal audits and financial system design and implementation. The Senate bill expands the list a little further. But neither bill requires the rotation of audit firms.

Where the Senate bill stands head and shoulders above the rest in this area is with its requirement that board audit committees, made up exclusively of independent board members, pre-approve any decision to hire the auditor to perform non-audit services. Also key is the Senate bill's provision making audit committees directly responsible for hiring and compensating the auditor and for overseeing the audit and giving the audit committee the tools it needs to do that job effectively.

While we respect the efforts the Senate has made to improve the oversight of the audit, we do not believe reform will be complete until auditors are forced to be truly independent from their audit clients. That means the kind of broad ban on consulting services that has been proposed by Senators Nelson, Carnahan, and McCain and mandatory rotation, as included in the Nelson-Carnahan bill.

Improve audit standards

Because they lack those broad auditor independence reforms, the House and Senate bills rely heavily on the new auditor oversight board to ensure quality audits. But only the Senate bill gives its new board the standard-setting authority that is key to its effectiveness. The House bill leaves authority for setting standards with the accounting profession. Even under pressure from recent scandals, the accounting profession uses its authority to write audit standards that are full of suggestions rather than mandates -- standards that are more geared toward minimizing accounting firms' liability than ensuring high quality audits.

The Senate bill provides ample opportunity for industry participation in this process, but it charges the oversight board with final responsibility. That should ensure that those whose job it is to protect the public interest, not the special interests, make decisions. Of course, even if the House bill gave its regulatory board the necessary authority, it would not matter. That is because, as we mentioned earlier, the House bill is custom designed to ensure maximum industry influence over its new

"regulator." It is essential that the Senate oversight board structure and authority be adopted in the final bill.

Increase deterrence

The Senate bill includes an impressive package of criminal and civil penalties for corporate crimes. These should send the same powerful message to white collar crooks that we have sent to street criminals -- don't do the crime if you can't do the time. The Senate and House have also authorized dramatically increased funding to put more cops on the beat at the SEC. You know as well as I do, however, that authorizing funding and appropriating it are two very different things. Particularly in light of the lack of administration support, members will need to be vigilant to ensure that this promise of increased resources is realized.

We also continue to believe that private lawsuits form an essential supplement to regulatory enforcement efforts, particularly if you are unwilling to adequately fund enforcement, as the President appears to be. Unfortunately, the deterrent effect of such lawsuits is limited by a number of factors, including the unreasonably high pleading standards plaintiffs must satisfy before getting access to discovery, the unreasonably short statute of limitations that governs such suits, and the lack of aiding and abetting liability.

The Senate bill would address one of those problems, lengthening the statute of limitations to two years from discovery, but no more than five years from the wrongdoing. This will make it more difficult for those who commit fraud to escape liability simply by keeping their fraud hidden for a short time. It will also make it less likely that suits against secondary defendants are dismissed because the statute of limitations has run while the motion to dismiss was pending, blocking access to discovery.

Senator Shelby was prepared to offer another important amendment, to restore aiding and abetting liability under the securities laws. Unfortunately, like so many other important amendments that we have discussed today, he was prevented from offering that amendment. This reform is highly relevant to the current crisis since the lack of aiding and abetting liability has been used by defendant after defendant in the Enron lawsuits to argue that they cannot be held accountable for assisting the fraud.

If you cannot fix this glaring shortcoming in our laws now under the current environment, it is hard to imagine when that will be possible. But perhaps when these lawsuits have worked their way through the court system and we find that the victims have recovered only a pittance, if anything, of their losses, perhaps then will certain members be willing to abandon their phony rhetoric about frivolous lawsuits and recognize that our legal system stands in the way of full and fair redress in even the most meritorious of cases.

Conclusion

The recent corporate crime wave has delivered a wake-up call. The system of corporate governance that we have grown accustomed to touting is broken. The Senate has started down the road to reform. But our system will remain vulnerable until we tackle the fundamental incentives that encourage our corporate executives to do the wrong thing and our auditors to turn a blind eye.

We have been given a wake-up call.